



United States  
Department of  
Agriculture

Food and  
Consumer  
Service

Mountain Plains  
Region

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Reply to  
Attn. of: CACFP-520

Subject: Use of the Internal Revenue Service (IRS) Form  
1040 and Eligibility Guidance for Family Day Care  
Homes Corrections

To: STATE AGENCY DIRECTORS - Colorado DPHE, Iowa, Kansas,  
(Child Nutrition Programs) Missouri DH, Montana DHHS  
Nebraska ED, North Dakota,  
South Dakota, Utah and  
Wyoming ED

In response to recent inquiries, we are issuing the following guidance on using IRS Form 1040 to verify a provider's household income when he/she attempts to qualify for Tier I status on the basis of household income. Also attached to this memo is guidance on when the Form 1040 should, and should not, be used as well as corrections to the Eligibility Guidance for Family Day Care Homes. The phrase "provider's household income," as it is used in this memorandum and the attachment, means the income of the family day care provider and the income of all other members of the household.

Although these inquiries have generally posed the question, "Which line on Form 1040 can we use to verify a provider's household income?" there is, in fact, no single line on Form 1040 which adequately captures "household income" as it is defined in CACFP. Nevertheless, because of the difficulties inherent in verifying the income of self-employed persons, Form 1040 will often be the best source of information for verifying household income, provided that the sponsor applies the guidance set forth in this memorandum and the attachment regarding the use of Form 1040 for verification purposes.

Because CACFP providers are self-employed, verification of their income eligibility for Tier I status will raise issues different from those which usually arise in verifying household applications for free or reduced price benefits in the National School Lunch Program (NSLP). In most places, self-employment is the exception among households sampled for NSLP verification. Because it is

usually possible to verify current household income in NSLP solely through the use of wage statements issued by employers, tax statements are generally viewed as a "last resort" for NSLP verification. In CACFP, however, all providers' households will include at least one self-employed individual and, in some cases (such as providers whose spouses are farmers or entrepreneurs), both spouses will be self-employed. Given these circumstances, guidance on the use of the prior year's IRS Form 1040 for verification is necessary, since it will be fairly common for sponsors to have no other readily available and reliable way to verify a provider's earnings from their child care operations. This memorandum will outline some of the differences between the way that household income is defined for CACFP and IRS purposes, while the attachment will discuss when it is and is not appropriate to use Form 1040 as the sole source of verification in CACFP.

The major differences between the CACFP and IRS definitions of income involve: the treatment of business losses; the treatment of distributions from pensions or other retirement plans; the exclusion or inclusion of certain types of income; and the use of deductions. In order to simplify the eligibility and verification process for determining officials, as well as to more accurately account for the resources currently available to a household attempting to qualify for a means-tested program, Congress amended the National School Lunch Act in 1980 and 1981 in order to eliminate previously allowable adjustments to income which IRS permits for tax purposes.

For example, when determining "income" for tax purposes, the IRS allows losses from business or investment to be deducted. However, the deduction of business or investment losses is not permitted in determining eligibility for benefits in any of the Child Nutrition Programs, including CACFP. Both the School Programs and CACFP Eligibility Guidance prohibit deduction of losses and require instead that, in this case, the loss be treated as "zero income." Thus, if a wage earner reports \$30,000 in income while his/her self-employed spouse reports a business loss of \$5,000 on line 12 of Form 1040, IRS would view "household income" as \$25,000, whereas the USDA Child Nutrition Programs would consider the household's income to be \$30,000.

Similarly, IRS may allow annual distributions from Individual Retirement Accounts (IRAs), pensions, and other retirement plans to be "adjusted" (i.e., only partially counted) for the purpose of determining taxable income, depending on various circumstances such as the source of the payment, the employee's age or share of the contributions, etc., which are irrelevant to the determination of income in the Child Nutrition Programs.

Specifically, lines 15, 16 and 20 on Form 1040 allow, under certain circumstances, a portion of annual distributions from pensions or retirement funds to be excluded from taxation. For the purpose of establishing income eligibility for CACFP and other Child Nutrition Programs, all of the retiree's annual income from such sources must be counted as part of household income.

Finally, IRS allows a number of forms of income to be excluded for tax purposes which the Child Nutrition Programs require to be included. Specifically, on line 21 of Form 1040, taxpayers are permitted to exclude child support, welfare benefits, and other forms of income which are countable for purposes of establishing eligibility for benefits in the Child Nutrition Programs. Family day care home sponsoring organizations must use the CACFP's Eligibility Guidance for Family Day Care Homes, Part II, Determining Individual Household Income Eligibility, in order to determine the rules for including or excluding these and other forms of income from the calculation of a household's total income and the determination of its eligibility.

Please note that this policy on the use of the Form 1040 is applicable to all Child Nutrition Programs, not just the CACFP.

Please contact my staff at (303) 844-0359 if you have any questions regarding this guidance.

*for Edward F. Campbell*  
ANN C. DEGROAT  
Regional Director  
Child Nutrition Program

Attachment

cc: Colorado ED  
Missouri DESE  
Wyoming DHSS  
Montana OPI

## Attachment

### Using the Form 1040

The purpose of this attachment is to provide information concerning when to use the prior year's IRS Form 1040 to verify a provider's household income for the purpose of establishing Tier I eligibility. This attachment also gives guidance on how to determine provider income when the IRS Form 1040 is not appropriate.

IRS Form 1040 is an excellent tool for sponsors to use in verifying the income of any of the provider's household members who are self-employed. Because they are self-employed, these individuals will lack the normal documentation of earnings (such as wage stubs or other records of pay) which are readily available to most wage earners. Although the use of the prior year's tax form to verify self-employment income does not provide information which is quite as current as a pay stub for wage earners, it often represents a reasonable estimate of a day care provider's current income without forcing either the provider or the sponsor to piece together current income from an inordinately large number of individual receipts for pay and expenses.

In some cases, however, a provider's household income may have changed significantly between the end of a tax year and the time when the provider applies for Tier I status on the basis of their household income. In such circumstances, it may be necessary for a sponsor to utilize sources other than, or in addition to, the Form 1040 to verify current household income. If, for example, there were two income earners in a household, the 1040 would not be useful as the sole source for verification if either person's income had changed substantially. Other examples of such circumstances could include:

(1) The household's composition has changed since the end of the prior tax year, due to a spouse's death or a change in marital status. In this case, the 1040 might still be an accurate representation of the remaining spouse's income, but the other spouse's income from the prior tax year would have to be excluded. In calculating and verifying current household income in such instances, please remember that the loss of some types of income may be at least partially replaced by other sources of income (e.g., separation or death will cause the loss of spousal income, but may be at least partially offset by other sources of income, such as child support, alimony, or survivor's benefits).

(2) Household income has changed markedly due to one member's loss or gain of regular employment. (Here, too, it is important to remember that the 1040 may still serve

as verification of income for another household member whose circumstances may not have changed, and that at least some portion of lost income may be offset by welfare benefits, unemployment compensation, or the like.)

(3) The provider's own income has changed as a result of gaining or losing children in day care. In this situation (where the sponsor should already be aware of this change as a result of changes to the provider's enrollment and meal claims), a reasonable attempt should be made to use the 1040 (and attached forms showing business expenses) as a basis for calculating the provider's new income for verification purposes. For example, the current income of a provider whose prior year earnings were based on providing care for two children for the entire year might reasonably be estimated to have doubled if the provider added two day care children on January 1st. However, sponsoring organizations are not expected to sort through boxes of receipts or to retain the services of tax consultants for the purpose of determining the provider's current household income. In some cases--such as when the provider has added several day care children with variable hours of care--it may be advisable for the sponsor to require the provider to fill out an estimate of his/her current year income and expenses on Schedule C of Form 1040 ("Profit or Loss from Business") or some similar statement of earnings and expenses.

(4) A new day care home provider who was either unemployed or employed in different pursuits in the prior year. In this case, IRS Form 1040 would not serve as a useful tool for verifying provider income (though it might, in some circumstances, suffice to verify other household members' income). The procedures for making eligibility determinations for new providers are outlined in the Eligibility Guidance for Family Day Care Homes, Part II, Determining Income for the Self-employed Provider.

Finally, when using the Form 1040 for verification purposes, sponsoring organizations should also take care to ensure that the entire household's income is reflected on the prior year's 1040. If, for example, the provider has used filing status "3" (Married, filing Separately), the sponsor would also have to review the Form 1040s for other income holders in the household.

#### Corrections to the Eligibility Guidance for Family Day Care Homes

1. There are misleading instructions on page 34 in the blocked area under "Determining Income for the Self-employed Provider". As a rule, providers may deduct the

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documented amount spent for food served to children while enrolled in care, and recorded on Schedule C of their Form 1040, even if this exceeds the amount received as CACFP reimbursement. Therefore, the second paragraph in the blocked area should be replaced with the following guidance:

If the provider does NOT have documentation of the actual amount spent, the sponsor may regard the amount received as CACFP reimbursement as the amount spent for food served to children, and allow the provider to deduct this from gross receipts as a business expense.

2. Under "Income Exclusions" on page 33, #14, TANF should be deleted. This sentence should read "(14) Child Care Development (Block Grant) Fund (P.L. 104-193) benefits."